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Regina M. Keeney, Chief
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Federal Communications Commission
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Washington, D.C. 20554

Re: PP Docket No. 93-253;
Request for Clarification With Respect
to Certain Aspects of FCC Designated Entity Rules

Dear Ms. Keeney:

As you know, prospective Designated Entity ("DE") participants in the upcoming "C-block" auction for broadband Personal Communications Services ("PCS") are rapidly preparing for the auction. A number of such participants, including many of our clients, have expressed uncertainty with respect to permissible forms of financing and structuring available to DE ventures under the Commission's rules.[1]

In response to these concerns, we have had several productive discussions with members of your staff and with members of the Office of Plans and Policy and the Office of the General Counsel. As a follow-up to these discussions, we believe that it would be useful

[1] These rules are primarily set forth in the Commission's Fifth Report and Order and Fifth Memorandum Opinion and Order in the above-referenced docket. See Fifth Report and Order, PP Docket No. 93-253, FCC 94-178 (released July 15, 1995), on reconsideration, Fifth Memorandum Opinion and Order, PP Docket No. 93-253, FCC 94-285 (released Nov. 23, 1995), Erratum (released Jan. 10, 1995).

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to our clients, and to other DE ventures as well, to have the Commission clarify formally, via letter ruling, certain aspects of its rules.

1. Treatment of Liquidation Preferences and Preferred Returns. The capitalization of start-up ventures of the type contemplated by the FCC rules frequently involves the issuance of multiple types of equity securities, each representing a different mix of "risk" and "reward." Such securities may be issued in successive "rounds" of financing and/or to investors with different investment requirements. The concepts of "liquidation preference" and "preferred returns" are fundamental to the variations among these types of equity securities and are essential elements in constructing a start-up company's capitalization.

Examples include the following:

(a) Convertible Preferred Stock. A start-up corporation often will issue both common stock and one or more series of "convertible preferred stock." Convertible preferred stock is (until converted) simply a preferred stock which entitles the holder to a fixed liquidation preference (usually in the amount paid for the stock) and in some cases the right to a preferential dividend in a fixed amount (e.g., 8% per annum). Once converted into common stock (at a specified "conversion ratio"), the holder loses its preferential rights and in return acquires the right to participate with other common stock holders in the "residual equity value" of the corporation. Typically, an investor pays significantly more for the convertible preferred stock than it would pay for the common stock into which the preferred stock is convertible. In return, if the investor chooses not to convert, the investor receives the protection of a return of capital (and in some cases a modest return on investment) prior to participation by the common stockholders. In an "upside scenario" (which invariably is the goal of both the investor and the company at the time the investment is made), the stock will be converted and the investor will participate on the same basis as the common stockholders.

The ability to provide this type of protection is critical to the ability of a start-up company to raise substantial amounts of equity capital without severely diluting the equity interests of the founders/entrepreneurs. The company may issue multiple "series" of convertible preferred stock, with "tiered" liquidation preferences -- e.g., investors in successive "financing rounds" may pay successively higher prices per "common share equivalent" but in return obtain successively more senior liquidation preferences.

(b) Non-Convertible Preferred Stock/Common Stock Units. In lieu of purchasing a convertible preferred stock, investors may be entitled to purchase "units" of non-convertible preferred stock and common stock. For example, each dollar invested might purchase $0.95 of non-convertible preferred stock (carrying the right to a return of capital and a fixed per annum dividend), and $0.05 may be allocated to the purchase of common stock. The preferred stock is economically much like a debt instrument, providing the protection of a return of capital and a fixed return on investment prior to participation by the common stockholders. However, the returns on the preferred stock are typically not sufficient to justify the investment without the ability to concurrently purchase the "upside" represented by the common stock. A variant would be the issuance of preferred stock with common stock "warrants" (i.e., the right to purchase common stock in the future at a fixed price).

(c) Preferences in the Partnership Context. An investment in a partnership differs from an investment in a corporation in a number of respects. (The comments herein pertaining to partnerships apply equally to limited liability companies, which are treated as partnerships for federal income tax purposes.) In a partnership, each of the partners contributes capital to the partnership and is credited with a "capital account," which initially equals the amount of such partner's capital contribution. In addition, each of the partners is afforded certain rights to allocations of partnership profits and losses, in accordance with specified percentages or other formulae contained in the partnership agreement. A partner's capital account is (i) increased by the amount of partnership profits allocated to its account; (ii) decreased by the amount of partnership losses allocated to its account; (iii) decreased by distributions from the partnership to the partner; and

(iv) increased by subsequent capital contributions made by the partner. Upon liquidation of a partnership, the partners are typically entitled to receive the balance in their capital accounts. Thus, over the life of the partnership, the aggregate distributions to a partner should generally equal the partner's capital contributions plus or minus the net profit or loss allocated to such partner.

Because of the way a partnership is structured, a partner receives a type of "preferential" right to return of capital, even if there is only a single type of "partnership interest." For example, assume Partner A and Partner B form a partnership and agree to split partnership profits equally, but Partner A contributes $1,000,000 and Partner B contributes $100,000. If the partnership were to liquidate the next day, the partners would not split the partnership's $1.1 million of capital equally, despite their "50/50" partnership interests. Rather, Partner B would receive a return of his $100,000 and Partner A would receive a return of his $1,000,000. Moreover, this $900,000 "disparity" in entitlement to partnership assets would carry forward indefinitely. For example, if the partnership generated $100 million in profits over its life, on liquidation Partner B would be entitled to $50,100,000 and Partner A would be entitled to $51,000,000.

In addition, most partnerships that attract financial investors use different classes of partnership interests that to a significant extent mirror the "preferred equity" distinctions used in the corporate structures described above. For example, in a simple structure, the limited partners of the partnership (e.g., financial investors) may be entitled to an allocation of virtually all of the partnership profits until they have been allocated a fixed "preferred return" (e.g., 8% per annum); at that point, future allocations of profits are disproportionately made to the general partner (e.g., the founder/entrepreneur) until the aggregate allocations to the limited partners and the general partner equal a specified percentage (e.g., aggregate profit allocations of 75% to the limited partners and 25% to the general partner). Moreover, whether or not such shifting allocations are utilized, preferential rights to partnership

> distributions may be provided; thus, for example, cash available for distribution to partners may be required to go first to return contributed capital and/or a fixed preferred return to investors, and only thereafter to the partners in accordance with their residual profit allocation interests. As is the case with corporations, more sophisticated partnership capitalization structures may include multiple "tiers" of preferential rights to allocations and distributions.

The Commission's DE rules contain a number of requirements related to the amount of "equity" in an applicant that must be held by qualifying investors. In addition, the definition of a "control group" under these rules sets out certain requirements for the dividends and liquidating distributions to be received by the control group, in relationship to the dividends and distributions received by other "equity" holders. The rules require clarification, however, regarding the treatment of preferred stock and other "preferential" equity rights in determining compliance with these requirements. Consistent with the spirit and intent of the DE rules, and the realities of the financial marketplace, we submit that the following clarifications should be made:

(i) *In calculating percentages of "equity" for purposes of compliance with the DE rules, the Commission will look only to the entity's "residual equity interests" -- i.e., common stock in a corporation and equivalent interests in a partnership.* Thus, non-convertible preferred stock (i.e., the right to receive a fixed liquidation preference based on contributed capital, plus a fixed percentage per annum return) would not be considered in calculating equity percentages. Convertible preferred stock would be counted in determining the equity percentages on an "as if converted" basis -- i.e., based on the number of shares of common stock into which it is convertible. (Similarly, the DE rules already provide that warrants to purchase common stock generally will be included in such calculations on an "as if exercised" basis.)

(ii) *In a partnership, "equity percentages" will be calculated based on rights to allocations of partnership profits.* Thus, neither a partner's inherent right to a return of the capital contributions credited to its capital account, nor "preferential distribution" rights, would be considered in determining equity percentages. Moreover, where the partnership agreement provides for a preferential allocation of a fixed "preferred return" on invested capital (i.e., the equivalent to a preferred stock dividend), equity percentages would be calculated based on the "residual equity" allocations. (For example, if the partnership agreement provided that profits were first allocated 99% to the limited partner until the limited partner had been allocated an 8% per annum return on its invested capital; next, were allocated to the general partner until the aggregate allocations to the general partner and limited partner were 25% and 75%, respectively; and, thereafter, were allocated 25% to the general partner and 75% to the limited partner, then the "equity percentages" of the general partner and the limited partner under the DE rules would be 25% and 75%, respectively.)

(iii) *The requirements of Section 24.720(k) (i.e., "control group" definition) will be interpreted in a conforming fashion.* Thus, for purposes of the requirement under Section 24.720(k)(2) -- that control group members receive "at least 50.1% of the annual distribution of any dividends paid on the voting stock of a corporation" -- the term "voting stock" would not be interpreted to refer to preferred stock, whether or not "voting." For purposes of the requirement of Section 24.720(k)(3) -- that in the event of dissolution or liquidation of a corporation, the control group be entitled to receive "a percentage of the retained earnings of the concern that is equivalent to the amount of equity held in the corporation" -- the reference to "equity" would be interpreted as referring only to common stock, and not to preferred stock entitled to a liquidation preference. For purposes of Section 24.720(k)(4) -- requiring that, for non-corporate entities, the control group have "the right to receive dividends, profits and regular and liquidating distributions from the business in proportion to the amount of equity held in the business" -- references to "equity" likewise would be interpreted as referring to residual equity interests and would not include rights to preferential allocations and/or distributions akin to preferred stock in a corporation. Similarly, references to "dividends" and "regular and liquidating distributions" would be interpreted as referring to residual equity distributions and would not include distributions of invested capital or preferred returns.

These clarifications are fully consistent with the FCC's orders and the intent of the DE rules. For example, in the Second Report and Order, the Commission expressly recognized that "there may be situations in which a designated entity may be able to best attract equity by offering investors such inducements as preferential dividends, liquidation preferences and other incentives typically offered to noncontrolling principals," and stated that it "[did] not intend to restrict the use of such financing mechanisms." Second Report and Order, PP Docket No. 93-253, 9 FCC Rcd 2348, 2396, ¶ 278. Likewise, in the Fifth Memorandum Opinion and Order, the Commission again stated that it "[did] not intend to limit the use of preferential dividends and liquidation preferences." Fifth Memorandum Opinion and Order at ¶ 82.

Moreover, the foregoing interpretations are consistent with the Commission's treatment of debt, which, like preferred stock, constitutes a commitment for return of a fixed amount together with a fixed return on investment. Indeed, debt is in many cases more burdensome than preferred stock to the economic interests of the common stockholders. Accordingly, it would be a mistake, and not consistent with the intent of the DE rules, to count preferred stock, but not debt, in determining the "ownership percentages" of designated entities. For these reasons, we believe the Commission should clarify the DE rules as set forth above.

2. Debt Terms. In general, debt financing is not considered under the DE rules in determining the affiliations or ownership interests of a designated entity. However, the Commission has observed that "commercially unreasonable" financing arrangements -- particularly arrangements that might provide lenders with unusual control over DE ventures -- may raise issues of attribution and affiliation.[2/] A number of DE ventures and prospective lenders have expressed concern as to what constitutes "commercially unreasonable" lending arrangements for such purposes.

[2/] See, e.g., Second Report and Order, at ¶ 272; ("financing agreements may result in a finding of affiliation if the debt relationship essentially give the creditor the power to control the enterprise--for example, if the size of the debt is particularly large, the terms of the loan are not commercially reasonable, and the definition of default is unconventional"); see also Answers to Questions Concerning Broadband PCS Auctions (issued by the Commission on October 20, 1994), at 7 ("Debt is not attributable unless it appears to be equity disguised as debt. Factors such as the interest rate and length of repayment period would have to be considered.").

In particular, concerns have been raised as to what constitutes a commercially reasonable rate of interest, given the widely divergent return requirements of different types of lenders providing financing at different levels of the capital structure. Venture capital firms and lenders to start-up ventures, particularly those that provide "seed" money or early-round financing, typically require a high rate of return commensurate with the high degree of risk associated with such financing. Thus, interest rates on venture loans, particularly in the context of "bridge" or temporary financing at the "control group" level, may be offered (if at all) only with returns in the 30% to 40% range. Accordingly, it would be helpful to DE participants if the Commission confirmed that such interest rates are not impermissible under the Commission's rules, provided that they are not coupled with other financing terms that indicate "control" on the part of the lender.

Similarly, concerns have been expressed by our clients about the extent to which the "length of repayment period" cited by the Commission (see note 2 above) might be a factor leading to a finding that financing terms were "commercially unreasonable." As is the case with other financing terms, debt maturity and amortization terms can vary significantly depending on the type of lender, type of loan, etc. Loans from commercial banks, for example, may require amortization to commence shortly after the loan is made, with amortization continuing over the life of the loan, sometimes with a "balloon payment" of remaining principal due at maturity. Many other types of loans have a single maturity date on which all principal (sometimes together with accrued and deferred interest) is due and payable. This maturity date could be as short as several months after the loan is made (in the case of bridge loans, short-term notes, etc.) or ten years or longer (in the case of a long-term note or amortizing bank facility). Furthermore, a ten-year amortizing bank facility may have the same "weighted average life" (i.e., the average period during which a dollar of principal is outstanding) as a six-year "bullet maturity" note. Some types of loans (e.g., a 30-year mortgage) are designed to fully amortize over the life of the loan, while other types of loans call for a large payment on the maturity date that will likely require refinancing on or before such date.

In this type of varied lending environment, we believe that there should not be any presumption in favor of (or against) any particular type of debt repayment terms. While there may be some ability for DE ventures to obtain "conventional" bank or equipment financing, the capital-intensive nature of a PCS start-up, and the delay between the time capital is needed and the time revenues will commence at a level sufficient to service debt, may militate toward bridge financings, "zero-coupon" or other deferred-interest debt and "bullet maturities." In many cases, a DE venture may require multiple refinancings as it progresses through various stages of its development. For these reasons, we seek clarification that the types of debt repayment terms discussed above would not (absent indications of abuse or other evidence of undue control) raise attribution or affiliation concerns.

3. Definition of Institutional Investor. In the Fifth Memorandum Opinion and Order, the Commission modified the DE rules to permit investment in the control group by "institutional investors." The term "institutional investor" was defined as

> an insurance company, a bank holding stock in trust accounts through its trust department, or an investment company as defined in 15 U.S.C. § 80a-3(a), including within such definition any entity that would otherwise meet the definition of investment company under 15 U.S.C. § 80a-3 but is excluded by the exemptions set forth in 15 U.S.C. § 80a-3(b) and (c), without regard to whether such entity is an issuer of securities; provided that, if such investment company is owned, in whole or in part, by other entities, such investment company, such other entities and the affiliates of such other entities, taken as a whole, must be primarily engaged in the business of investing, reinvesting or trading in securities or in distributing or providing investment management services for securities.

See Fifth Memorandum Opinion and Order at Appendix B (Section 24.720(h)); Erratum (released Jan. 10, 1995). We assume, and seek clarification, that the entities deemed to "own" the institutional investor for purposes of the foregoing proviso are only those entities owning a controlling interest in the investor and not entities that own passive, non-controlling interests (e.g., limited partnership interests) in the investor.

The Commission's stated purpose in making the institutional investor modification was to provide the control group with access to equity financing from venture capital firms, merchant banks and similar funding sources. However, venture capital firms and merchant banks typically make their investments through "funds" (i.e., entities, often in limited partnership form) that are managed by the venture capital firm or merchant bank, but that include substantial passive "ownership" by a variety of entities that may not meet the requirements stated in the proviso. For example, a venture capital firm ("VentureCo"), that is in the business of sponsoring and managing investments, may form a limited partnership ("Venture Fund") of which VentureCo and/or one of its affiliates is the general partner. VentureCo and Venture Fund would then solicit various persons -- pension funds, banks, university endowment funds, or other entities and individuals seeking high return and high risk investments -- as limited partners of Venture Fund. Typically, these limited partners make "commitments" to the partnership, pursuant to which "capital calls" are made from time to time as and when Venture Fund identifies suitable investments. It is not unusual for the limited partners to provide up to 99% of Venture Fund's capital, with VentureCo earning its return through a "carried interest" in Venture Fund (i.e., the right to receive a specified percentage of Venture Fund's profits after the limited partner investors have been allocated a "preferred return.")

If the proviso to the institutional investor definition were interpreted so as to require the limited partners of such a Venture Fund to be "primarily engaged in the business of investing, reinvesting, or trading in securities," the qualifications of most venture capital and merchant bank funding sources could be called into question. Since the participation of these funding sources was the express goal of the Commission in adopting the "institutional investor" modifications, we believe the above-requested clarification is appropriate.

4. Definition of "Management". In the Fifth Memorandum Opinion and Order, the Commission also made provision for the equity participation of "management" in the control group. While the Commission did not define the scope of "management," we believe its intent was (among other things) to enable the types of equity-based incentives typically provided by corporations and other business entities. Such equity-based incentives are often provided not only to officers and key employees of the business entity, but also to directors and other individuals providing significant services to the business, whether or not officers or full-time employees of the business. Accordingly, we seek clarification that directors and persons providing significant services to the control group, as well as the control group's officers and employees, may appropriately be considered as "management."

5. Status of Super-Voting Stock. The DE rules explicitly recognize that there may be a disparity between the equity ownership interests of qualifying investors and their control rights -- i.e., the equity interests of qualifying investors may be as low as 15% of the equity of the designated entity, but the qualifying investors must still retain control of the designated entity. See, e.g., Fifth Memorandum Opinion and Order at ¶ 64 and Appendix B (Section 24.709(b)(3)). One method of ensuring this control is the use of "super-voting stock." For example, qualifying investors could hold a class of common stock representing 25% of a designated entity's common stock, but carrying the rights to five votes per share, while other investors would hold a class of common stock carrying only one vote per share. We believe the use of such super-voting stock is fully consistent with the DE rules (and, indeed, in some cases may be the most appropriate mechanism for implementing the express requirements of the DE rules).

Section 24.720(k)(2) requires that the control group and/or its members "receive at least 50.1% of the annual distribution of any dividends paid on the voting stock of a corporation." Read literally, this requirement might suggest, in the example cited above, that the qualifying investors holding only 25% of the corporation's stock would nevertheless be entitled to 50.1% of the corporation's distributions to stockholders. If interpreted in this manner, we believe this provision would effectively prohibit the use of super-voting stock as a vehicle to maintain control by qualifying investors, and we believe this clearly was not the intent of the Commission. Accordingly, we suggest clarification that, in cases where a control group's 50.1% control interest in a designated entity is achieved through mechanisms other than ownership of 50.1% of the corporation's voting stock (such as through use of super-voting stock), the distributions of dividends to the control group need only be commensurate with the control group's equity interests.

We respectfully request that the Commission clarify formally the issues raised in this letter via letter ruling.

Sincerely,

Bruce E. Rosenblum

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